Supreme Court, U.S.
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No. 01-739

IN THE

Supreme Court of the United States

MORGAN CAPITAL, L.L.C.,

Petitioner,

v.

MEDTOX SCIENTIFIC, INC.,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

REPLY BRIEF

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PARTIES AND 29.6 STATEMENT

Respondent, Medtox Scientific, Inc., was formerly known as Editek, Inc.

Petitioner, Morgan Capital, LLC, has no parent corporation and no publicly held company owns 10% or more of its stock.

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PRELIMINARY STATEMENT

Petitioner Morgan Capital, LLC ("Morgan Capital") respectfully submits this reply brief to address the points raised by respondent Medtox Scientific, Inc. ("Medtox") in its brief in opposition to the petition.

The thrust of Medtox's argument is that the Eighth Circuit Court of Appeals correctly decided the case before it. Yet, while one can argue for or against the holding of the Eighth Circuit in this case, it is plain that the issues presented warrant this Court's intervention and grant of the writ. The Eight Circuit's ruling is a novel one, and one that potentially causes massive confusion in this multi-billion dollar securities market. Such issues of national importance should be decided by the Supreme Court for all jurisdictions, to provide uniformity and certainty.

While implicitly recognizing that the Eighth Circuit treated hybrid fixed-price/floating -price convertible securities as non-derivative floating-price convertible securities only, Medtox argues that this Court should ignore the issue because it was supposedly not raised in the courts below. As we mentioned in our principal brief, all of the courts below dealt first with the issue of 10% beneficial ownership. As we explained, prior to actual conversion of the Medtox convertible preferred securities, the precise percentage ownership could not be determined so long as there was a floating-price feature to the security. The Eighth Circuit's holding, however, now goes beyond that, by ignoring any aspect of the security having a fixed-price component and thereby determining that the actual conversion of the security should be deemed a separate purchase for invoking liability under section 16(b) of the Securities Exchange Act of 1934 (the "Exchange Act").

It is also disingenuous for Medtox to claim that *certiorari* should be denied because the Eighth Circuit's holding does not conflict with any other appellate court decision. One conflicting decision is already on appeal to the Second Circuit, *Levy v. Oz Master Fund, Ltd.*, 00 Civ. 7148 (AGS), 2001 U.S. Dist. LEXIS 9251 (S.D.N.Y. July 9, 2001). More importantly, the issues at

hand present matters of national importance. Uniformity in the regulation of the securities markets is warranted.

Finally, the Eight Circuit's decision was incorrect. The court ignored the requirement that there be *three separate transactions* in order to invoke liability under section 16(b) of the Exchange Act. The court improperly counted the hypothetical conversion of the convertible preferred and the subsequent actual conversion *of the same securities* as two separate transactions. According to the Eighth Circuit, one can become a 10% beneficial owner of equity securities, although not actually owning any of the securities, based on a possibility; i.e., that the person *could have* acquired those securities *if* it had exercised its conversion right (even if the person in fact did not exercise the right). Such a theory of section 16 liability negates SEC Rule 16a-2(c)'s requirement that the transaction which makes one a beneficial owner of more than 10% of the equity securities of the issuer cannot serve also as the transaction for which section 16(b) profit recoupment is sought. The court's holding also relies on rank speculation, creating a category of 10% beneficial ownership solely on the possibility of conversion.

The Eighth Circuit fashioned new rules for holders of convertible preferred securities that are contrary to the spirit *and* text of the governing rules and pronouncements of the SEC. This multi-billion dollar securities market warrants that the Supreme Court of the United States review the matter and pronounce the rules to be followed by all such securities holders no matter which jurisdiction a plaintiff chooses in contemplation of its section 16(b) lawsuit.

ARGUMENT

I. THE IMPORTANCE OF PETITIONER'S THIRD "QUESTION PRESENTED" WARRANTS REVIEW BY THE SUPREME COURT

Like an ostrich with its head in the sand, Medtox resorts to hyper technicalities in order to persuade this Court that it should deny consideration of the following issue:

> Is a convertible security with both fixed and floating conversion price features deemed a "derivative" security under the Exchange Act so that the actual conversion of the security would not constitute a purchase under the Exchange Act and render the owner liable for a subsequent sale made within six months of the conversion. (Petition for Writ of Certiorari, at i.)

This issue places the Eighth Circuit opinion here diametrically opposite to the holdings of the district courts in the Second Circuit. Its effect is national in scope. It certainly warrants review by this Court so that the answer to the above question does not rest upon the particular jurisdiction chosen by a plaintiff's lawyer for commencing suit.

The reason this particular issue could not be addressed at any length before the Eighth Circuit rendered its decision was stated plainly in petitioner's principal brief (at page 15). The courts below in this case all focused on, first, whether Morgan Capital was a beneficial owner of Medtox common stock by virtue of its purchase of the Medtox convertible preferred securities, and, second, even if Morgan Capital was a beneficial owner, whether it was a 10% beneficial owner thereby making Morgan Capital a statutory "insider" for purposes of section 16(b) of the Exchange Act. This depended on the effect the floating-price feature of the security had on Morgan Capital's ability to acquire a specific number of shares of Medtox common stock. As Medtox correctly points out, throughout the litigation Morgan Capital maintained that the floating-price feature of Medtox's convertible preferred stock precludes the determination that a finite number of shares was acquired prior to actual conversion, let alone 10% of the outstanding common stock.

The import of the Eighth Circuit's holding, however, now goes beyond determining whether Morgan Capital was a 10% beneficial owner. The holding of the Eighth Circuit completely ignores the fixed-price feature of the security, because only by

doing so could the actual conversion of the Medtox convertible preferred stock in May 1996 be deemed a separate "purchase" for purposes of invoking section 16 liability for a subsequent sale made within six months.

Thus, it is one thing for the Eighth Circuit to hold that the convertible preferred was not a "derivative" security for purposes of establishing 10% beneficial ownership. But to do so in the context of establishing the necessary transactions for section 16(b) liability (a matching purchase and sale) negates the fixed-price aspect completely. If the fixed-price feature is considered, then the actual conversion could not be deemed a "purchase."

The characteristics of the Medtox convertible preferred stock–its floating-price and fixed-price features–were plainly in the Record on Appeal. JA 182-83. In addition, contrary to Medtox's suggestion, this issue, i.e., the effect of ignoring the fixed-price feature of the security by deeming the actual conversion of the security as a separate "purchase" for purposes of section 16(b) of the Exchange Act, was discussed in Morgan Capital's principal brief on its appeal to the Eighth Circuit (at pages 34-35):

> In addition, the district court's 10% beneficial ownership rule either rendered the Medtox convertible preferred a "derivative," in which case the exercise of the conversion right was exempt under Rule 16b-6(b), or did not affect its non-derivative status, in which case the exercise was exempt under Rule 16a-13. . . .

Morgan Capital's argument was and is straightforward: either the Medtox convertible preferred is or is not to be treated as a derivative. In either case, and as explained in greater detail in Point III below, the Eighth Circuit's ruling contravenes the regulatory framework established by the SEC and makes no sense.

Finally, the cases cited by Medtox to support its argument (that questions never presented below are not to be considered by this Court) are inapposite even if Morgan Capital had made

no reference to the fixed-price issue in the courts below. In each of Medtox's cases, *National Collegiate Athletic Ass'n v. Smith*, 525 U.S. 459, 469 (1999); *Roberts v. Galen of Virginia, Inc.*, 525 U.S. 249, 253-54 (1999); and *Youakim v. Miller*, 425 U.S. 231, 234 (1976), although issues were not passed on by the lower courts, the lower courts would have another opportunity to address them on remand by the Supreme Court. Moreover, as stated by the Court in *Youakim*, "the rule is not inflexible." 425 U.S. at 234. The Court held it appropriate to afford the appellants the opportunity to press the issue of a conflict between state and federal law. *Id.* at 236. We respectfully submit that the issue of the treatment of convertible preferred securities with hybrid conversion features, especially given the conflict between the lower courts on this issue, merits review by this Court.

II. THE COURTS THAT HAVE ADDRESSED THE APPROPRIATE TREATMENT OF CONVERTIBLE SECURITIES WITH HYBRID CONVERSION PRICE FEATURES HAVE ISSUED CONFLICTING RULINGS

Medtox dismisses the decision of the United States District Court in *Levy v. Oz Master Fund, Ltd.*, 00 Civ. 7148 (AGS), 2001 U.S. Dist. LEXIS 9251 (S.D.N.Y. July 9, 2001), as not important enough to be considered as creating a conflict with the Eighth Circuit. While it is true that thus far no circuit court except for the Eighth Circuit Court of Appeals has addressed the issue, that is about to change. The *Levy* decision is on appeal to the Second Circuit and, if affirmed, would directly conflict with the Eighth Circuit's holding in our case.

Of course, *Levy* is not the only lower court case to have addressed the issue. *See Levy v. Clearwater Fund IV, Ltd.*, 2000 U.S. District LEXIS 1305, No. Civ. A. 99-004-SLR (D. Del. Feb. 2, 2000); *Lerner v. Millenco, L.P.*, 23 F. Supp. 2d 337 (S.D.N.Y. 1998).

This is not just a matter of counting up the number of courts that have addressed the issue and are in conflict, or how many times appellate review has been obtained. The importance of

this issue cannot be gainsaid. Convertible securities are a billion dollar industry of national scope. Their regulation must be uniform–which only this Court's review can insure.

III. THE EIGHTH CIRCUIT'S DECISION WAS INCORRECT

As we pointed out in our principal brief, the Eighth Circuit's decision is illogical and contrary to SEC pronouncements. The following responds to the specific arguments raised by Medtox in its Brief in Opposition.

A. The Eighth Circuit Erred in Deeming Morgan Capital a 10% Beneficial Owner Prior to Actual Conversion of the Convertible Preferred Stock

Medtox acknowledges the hypothetical nature of the transaction prior to actual conversion by which the Eighth Circuit held that Morgan Capital was not only a beneficial owner of common stock, but also an owner of more than 10% of the stock. *See, e.g.*, Medtox Brief at 10 ("The court reasoned that Morgan Capital had the right to convert . . . and that, *had it done so* . . . Morgan Capital would have received . . . more than ten percent. . . ." (emphasis added)).

The SEC's 1991 Release,[1] which discusses derivatives and convertible securities, does not carve out special rules for hypothetical conversions. There is simply no such thing as an imaginary conversion before the actual exercise of the conversion right. As stated in the 1991 SEC Release:

> a right with a floating exercise price is not required to be reported and will not be deemed to be acquired or purchased, for section 16 purposes, until the purchase price of the underlying securities becomes fixed or established, which commonly occurs at exercise.

1991 SEC Release, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) par. 84,709, at 81,265.

1. The "1991 SEC Release" refers to Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) par. 84,709 (Feb. 8, 1991).

The SEC's analysis is straightforward. If the Medtox convertible preferred fixed-price conversion feature is considered, then the section 16(b) analysis never even begins, for in that event the acquisition of the securities occurred at the time of the purchase of the preferred stock. If the floating-price conversion feature is considered, then the first transaction in our case that could conceivably constitute the acquisition of Medtox common stock occurred at the time of the actual exercise of the conversion right. Whatever *could have* or *might have* been acquired before actual conversion does not constitute a section 16 *transaction*—whether for purposes of meeting the 10% beneficial ownership threshold or otherwise.

SEC Rule 13d-3(d)(1)(i) (incorporated into the Rule 16 regulations) also refutes the notion that a hypothetical conversion can render a person a 10% beneficial owner of securities for section 16 purposes. The Rule provides: "[a]ny securities not outstanding which are *subject to* such options, . . . or conversion privileges shall be deemed to be outstanding for the purpose of computing the percentage of outstanding securities of the class owned by such person. . . ." 17 C.F.R. § 240.13d-3(d)(1)(i) (emphasis added). Before actual conversion, this computation of the number of outstanding equity securities beneficially owned cannot be made in any finite manner. The number would always be a moving target.

Medtox assumes erroneously that since Morgan Capital had the right to acquire Medtox common stock through conversion of its preferred, that means that Morgan Capital could acquire more than 10% at its whim. That notion is plainly wrong. The determination that Morgan Capital beneficially owned more than 10% of Medtox common stock is not "mere math" as Medtox characterizes it. (Medtox Brief at 14.) It cannot be determined based on hypothetical and speculative transactions. Morgan Capital never had the right to acquire 10% of the outstanding common stock of Medtox before Morgan Capital actually converted the preferred stock and the five-day trailing average "look-back" floating exercise price was computed. For

that matter, before actual conversion, Morgan Capital had no right to acquire any specific amount of Medtox common stock.

Finally, in an attempt at revisionist history, Medtox suggests that Morgan Capital's statement that its acquisition of more than 10% of the outstanding common stock was an unintended event and really due to Medtox running out of a sufficient amount of stock to meet conversion demands, is not true because it is unsupported by the record. (Medtox Brief at 11.) Morgan Capital's contention is far from new. It was included in the briefs to the Eighth Circuit without any real suggestion by Medtox at the time that it was in any way inaccurate. The fact is that Medtox did run out of common stock. And the statement is supported in the Record. It is referred to in the defendants' Amended Answer and Counterclaim, at ¶ 49.

B. Treating Morgan Capital's actual conversion as a separate "purchase" is illogical and inconsistent with the regulatory scheme

The issue is not as Medtox describes it, i.e., whether a "conversion" can be considered a "purchase" under section 16(b) of the Exchange Act. No one argues with that principle. Here, however, the situation concerns a hypothetical conversion followed by an actual conversion. The same shares of Medtox common stock involved in the hypothetical conversion that rendered Morgan Capital a beneficial owner of more than 10% of the outstanding common stock of Medtox magically reappear at the time of actual conversion and, according to the Eighth Circuit, can be counted again to invoke liability under section 16(b). It is this novel approach to the statute and the rules that finds no support in logic, case law or in the regulations.

The cases cited by Medtox in its Brief (at pages 12-13), *Park & Tilford, Inc. v. Schulte*, 160 F.2d 984 (2d Cir.) *cert. denied*, 332 U.S. 761 (1947); *Blau v. Lehman*, 286 F.2d 786 (2d Cir. 1960) *aff'd*, 368 U.S. 403 (1962); and *Heli-Coil Corp. v. Webster*, 352 F.2d 156 (3d Cir. 1965), are not on point. In our case, the Eighth Circuit held that a hypothetical conversion renders one a holder of more than 10% of the underlying equity

security and, if followed by actual conversion, then subjects the holder to potential liability if the stock were sold within six months of actual conversion. None of Medtox's cases speaks to this issue, for all involved a transaction by one already a statutory "insider" as opposed to a transaction (albeit in our case a hypothetical transaction) that makes one an "insider" in the first place.

Medtox also takes the 1991 SEC Release out of context when it suggests that the SEC supports the treatment of a hypothetical conversion and subsequent actual conversion as two separate transactions. (Medtox Brief at 12.) If the fixed-price feature of the convertible is considered, then, as explained above, the actual conversion would be a non-event under the SEC regulations. If the Medtox convertible preferred is to be deemed a floating-price convertible, then the governing regulations and SEC pronouncements indicate plainly that an owner of floating-price convertible securities cannot be deemed a 10% beneficial owner before the day of actual exercise of the conversion right. The SEC made it very clear in its 1991 Release that the *exercise* of a non-fixed-price convertible security is the event that constitutes the "purchase" of the underlying equity securities for purposes of section 16 of the Exchange Act. It is actual conversion that takes the holder above the 10% threshold for the first time and, therefore, as a matter of law the actual conversion cannot be the transaction that invokes liability under section 16(b) of the Exchange Act. 17 C.F.R. § 240.16a-2(c).

C. "Conversion Caps" are not the solution

In our principal brief, we described the confusion generated by the hypothetical rule espoused by the Eighth Circuit, as investors and this multi-billion dollar marketplace attempt to keep track of changes in corporate control. We also pointed out that "conversion caps," like those suggested by Medtox (Medtox Brief at 15), are not the solution. Uniformity in securities regulation should be the answer; not artificial ceilings inserted in legitimate business contracts merely because the courts cannot see eye to eye on the issue.

Contractual arrangements between issuers and shareholders should not be arbitrarily abridged or restricted simply because of the possible adverse effects arising from the application of section 16 of the Exchange Act to future transactions. Convertible securities are not unlawful. Their use is widespread, especially in promoting the growth of relatively younger companies. Their utility cannot and should not be restricted.

Conversion caps also may be waived, which would moot their usefulness as section 16(b) antibodies. For example, in *Global Intellicom, Inc. v. Thomson Kernaghan & Co.*, 1999 U.S. Dist. LEXIS 11378, *14-15 (S.D.N.Y. 1999), cited by Medtox (Brief at 16), the conversion formula in the operative agreement provided that the conversion cap "may be waived by the Purchaser upon not less than 75 days prior notice to the Company. . . ."

Finally, unless all convertible securities have conversion caps—which is a virtual impossibility—the market place still cannot rely on the integrity of the reporting process if those floating in and out of 10% ownership are subject to Section 16. A principal purpose of section 13(d)'s reporting requirements is to "allow[ ] investors to be informed of potential changes in corporate control and permit[ ] the market to value the shares accordingly." *General Aircraft Corp. v. Lampert*, 556 F.2d 90, 94 (1st Cir. 1977). *See GAF Corp. v. Milstein*, 453 F.2d 709, 717 (2d Cir. 1971) *cert. denied*, 406 U.S. 910 (1972) (purpose of section 13(d) is to "alert the marketplace to every large aggregation or accumulation of securities"). The marketplace is not served by conversion caps that can be waived, overridden, ignored or not enforced.

The answer to the conflicting approach by the courts in the area of convertible preferred securities is to have this Court speak on the issue, thereby promoting uniformity and certainty in this multi-billion dollar securities marketplace.

CONCLUSION

For all of the foregoing reasons, petitioner respectfully urges the Court to grant this petition.

Respectfully submitted,

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